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## **Adam Smith's View on the Functions of Taxation.**

### **Streszczenie**

Ojciec klasycznej ekonomii, Adam Smith, znany jest z metafory niewidzialnej ręki. Bywa to powodem utożsamiania go ze radykalnymi zwolennikami wolnego rynku i państwa nocnego stróża. Analiza jego poglądów na funkcje opodatkowania może pomóc zweryfikować stopień, w jakim był on oddany „niewidzialnej ręce rynku”. Opodatkowanie ma trzy główne funkcje: fiskalną, regulacyjną i stymulującą. Radykalni liberałowie ekonomiczni i zwolennicy państwa minimalnego zgadzają się wyłącznie na funkcję fiskalną. Adam Smith wierzył, że podatki inne daniny publiczne powinny być wykorzystywane do redystrybucji dochodu. Można dostrzec w jego analizie opłat drogowych oraz podatku od dochodów z najmu. Opowiadał się także za regulacyjną funkcją podatków. Co więcej, proponował wykorzystanie opodatkowania do promowania szczególnych form dzierżawy ziemi, uznawanych przez niego za bardziej korzystne dla społeczeństwa od innych. Proponował także ulgi podatkowe na badania i rozwój. Należy zatem uznać, że popierał także stymulacyjną funkcję opodatkowania. Podsumowując, Adam Smith jest jednym z najbardziej wpływowych ekonomistów liberalnych, ale daleko mu od bycia neoliberalnym czy libertarianinem. Wierzy on, że państwo powinno czasami interweniować w gospodarce, a podatki są właściwym narzędziem do tego celu.

**Słowa kluczowe:** Adam Smith, opodatkowanie, niewidzialna ręka rynku.

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## ***Introduction***

The failure or non-existence of the invisible hand of the market are slogans very frequently used<sup>1</sup> by critics of policies called more or less accurately *neoliberal economy*. The phrase “invisible hand of the market” is often wrongly attributed to the Scottish philosopher and the father of classical economy, Adam Smith, the author of *The Wealth of Nations*. What is more, the metaphor of “invisible hand” was used by many thinkers and writers before Smith, including Shakespeare, Voltaire and Defoe, but Smith himself employed it quite sporadically and without the “market” context<sup>2</sup>. The invisible hand cliché mistakenly evokes associations between Adam Smith and radical economic liberals, including libertarians, neoliberals etc. The analysis of functions of taxation put forward by Adam Smith in his proposals concerning the fiscal system will probably be helpful while verifying Smith’s allegedly strong beliefs in the invisible hand.

## ***Functions of taxation and economic liberalism***

The contemporary theory of taxation makes a distinction between three main functions of taxes: fiscal, regulatory and stimulating<sup>3</sup>. The first and oldest one is the fiscal function. It consists in the tax being used to raise revenues for the budget, thus enabling states to maintain their institutions and perform various duties<sup>4</sup>.

The regulatory function of taxes is aimed at shaping the income and capital of taxpayers<sup>5</sup>. Put simply, taxes are used by state for the redistribution of income. Therefore, this function is sometimes called the redistributive function<sup>6</sup>.

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<sup>1</sup> It is enough to take look only at the titles of many economic books and papers to notice this pattern. For instance: J. Schlefer, *There Is No Invisible Hand*, “Harvard Business Review”, 2012, <https://hbr.org/2012/04/there-is-no-invisible-hand>, 3.05.2016; J. Stiglitz, *There is no invisible hand*, “The Guardian”, 2002, <http://www.theguardian.com/education/2002/dec/20/highereducation.uk1>; R. Amir-ud-Din, A. Zaman, *Failures of the “Invisible Hand”*, “Forum for Social Economics”, 2015, <http://dx.doi.org/10.1080/07360932.2015.1019536>, 3.05.2016; G. B. Gorton, *Slapped by the Invisible hand: The Panic of 2007*, New York 2010.

<sup>2</sup> vide G. Kennedy, *Adam Smith and the Invisible Hand: From Metaphor to Myth*, “Econ Journal Watch”, 2009, vol. 6(20).

<sup>3</sup> R. Wolański, *System podatkowy w Polsce*, Warszawa 2009, p. 27.

<sup>4</sup> A. Gorgol, A. Kuś, P. Smoleń, *Zarys finansów publicznych i prawa podatkowego*, p. 18.

<sup>5</sup> R. Wolański, *op. cit.*, p. 30.

<sup>6</sup> A. Gorgol, A. Kuś, P. Smoleń, *op. cit.*, p. 19.

The last function of taxation is the stimulating one. This function is aimed at influencing the taxpayer's choices. A state can encourage certain behaviours by lowering taxes which are related to them, or, by way of contrast, discourage some forms of conduct by increasing the relevant taxes<sup>7</sup>.

The acceptance of particular functions of taxation in the fiscal system is a political matter. The fiscal function stems from the definition of taxation. The Encyclopaedia Britannica says: "taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes as well"<sup>8</sup>. The fiscal function is the main function of taxation and the basic role of taxes is to raise revenue. Other functions are popular nowadays but these are of secondary importance. Their approval is not common unlike the fiscal one. For instance, libertarian circles criticize especially the stimulating function and they consider it as some kind of leftist policy and undesirable social engineering<sup>9</sup>. Members of the Austrian School of Economics are also against the use of taxes for purposes other than revenue-raising because they believe that a tax should be neutral<sup>10</sup>. It is worth finding out whether the author of *The Wealth of Nations* shares their views.

The aim of this article is to analyze Adam Smith's proposals regarding taxation from the perspective of the modern classification of taxation functions as described above. As it has been shown, hard core free market liberals, libertarians, supporters of the Austrian School of Economics, etc. accept the first of the tax functions solely – the fiscal one. Therefore, Smith's possible advocacy of taxes designed to implement other functions would be quite a convincing proof that the Scottish philosopher was a predecessor of more moderate centrist social liberalism rather than the questionable patron of the supporters of neoliberalism with the unlimited free market and the night-watchman state. As the existence of the fiscal function stems from the nature of the fiscal system and it occurs in every case of taxation being generally

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<sup>7</sup> *Ibidem*, p. 18-19.

<sup>8</sup> F. Neumark, *Taxation* [in:] *Encyclopaedia Britannica*, <http://www.britannica.com/topic/taxation>, 3.05.2016.

<sup>9</sup> T. Sowell, *The Busybody Left: Using Taxes for Regressive Social Engineering*, "Capitalism Magazine", 4.1.2016, <http://capitalismmagazine.com/2016/01/the-busybody-left-using-taxes-for-regressive-social-engineering/>, 03.05.2015.

<sup>10</sup> L. von Mises, *Human Action*, Auburn 1998, p. 767-768.

independent from political views<sup>11</sup>, research will be focused on the regulatory and stimulating functions.

### *Adam Smith on the regulatory function of taxes*

Adam Smith's opinion on the regulatory and stimulating functions of taxation can be reconstructed from his analysis of the British fiscal system and his ideas of potential reforms in that area. Smith's proposals in that matter can be found in Chapter 2 of Book 5 of his *opus magnum*, *An Inquiry into the Nature and Causes of the Wealth of Nations*<sup>12</sup>. Significantly, the whole chapter which deals with taxes is entitled: "Of the Sources of the General or Public Revenue of the Society". It can be concluded at first glance that the fiscal function is the most important objective of taxation for the Scottish philosopher. Public levies should serve primarily as a way of financing justified and necessary expenses of the government, which is described in the preceding chapter.

At the very beginning of his analysis of the tax system, Adam Smith notes that taxpayers should contribute to the budget of the state proportionally to their revenue<sup>13</sup>. This means that the most liberal tax concept accepted by the father of classical economics is the proportional tax with a flat rate. As early as at this point the paths of Adam Smith and the neoliberals diverge. For the latter, flat tax is already a compromise. Neoliberals consider a poll tax (defined as a tax of a uniform, fixed amount levied on each taxpayer<sup>14</sup>) as a most just solution. Margaret Thatcher's government tried to introduce it in the 1970s under the name of community charge, which led to strong protests and was one of the main causes of the fall of the Iron Lady<sup>15</sup>. Adam Smith openly opposes the poll tax. He believes that such a tax has its origins

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<sup>11</sup> It should be noted that only the existence of the fiscal function of taxation is independent from political views. The intensity of implementation of this function is heavily reliant on the political ideology. For instance, taxation is significantly higher in welfare states (e. g. Sweden) than in the countries of pure neoliberal economy (e. g. Ronald Regan's USA).

<sup>12</sup> This book more widely known under the abbreviated title: *The Wealth of Nations*.

<sup>13</sup> A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, vol. 2, p. 825.

<sup>14</sup> Poll tax [in:] *Encyclopaedia Britannica*, <http://www.britannica.com/topic/poll-tax>, 3.05.2016.

<sup>15</sup> D. Burns, *Poll tax rebellion*, Balmoral Place – London 1992, p. 9-20.

in the age of slavery and when levied on free people, it is arbitrary and unequal<sup>16</sup>. Consequently, proportional tax is the most liberal concept approved by the author of *The Wealth of Nations*.

However, even the proportional taxation wouldn't be enough for Adam Smith. On the next few pages, in the section of *The Wealth of Nations* devoted to the taxes on real estate, he suggests that the best way of taxation of buildings will be levy amounting to a certain percentage of the actual cost of renting a particular house. The amount of payable tax would be determined on the basis of a public register of rental contracts. Smith is aware that ultimately the tax on house-rents will be passed on to tenants. What is more, he perceives it as a tool for redistribution of income.

The Scottish philosopher writes in his *opus magnum*: "The proportion of the expense of house-rent to the whole expense of living is different in the different degrees of fortune. It is perhaps highest in the highest degree, and it diminishes gradually through the inferior degrees, so as in general to be lowest in the lowest degree. The necessities of life occasion the great expense of the poor. They find it difficult to get food and the greater part of their little revenue is spent on getting it. The luxuries and vanities of life occasion the principal expense of the rich; and a magnificent house embellishes and sets off to the best advantage all the other luxuries and vanities which they possess. A tax upon house-rents, therefore, would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be any thing very unreasonable. It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion"<sup>17</sup>. In this excerpt Adam Smith proposes an interesting solution for income redistribution. Although such a tax on house-rents is not a classical progressive tax (tax rate does not increase while the taxable amount grows), the Scottish philosopher clearly argues for the possibility of introducing progressive taxation<sup>18</sup>, which can be concluded from Smith's predictions of the economic impact of a house-rent tax.

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<sup>16</sup> A. Smith, *op. cit.*, p. 857.

<sup>17</sup> A. Smith, *op. cit.*, p. 842.

<sup>18</sup> P. Baum, *Poverty, Inequality, and the Role of Government: What Would Adam Smith Say?*, "Eastern Economic Journal", 1992, Vol. 18, No. 2, p. 153.

The author of *The Wealth of Nations* believes that the rich spend significantly higher percentage of their income on housing than the poor. The latter are forced to spend most of the income on foodstuffs and other basic commodities while the rich can afford to rent luxurious apartments. As a result, the effective tax rate for the upper class would be much higher than the taxation of the poorest. Smith notices that the public levy which formally has the flat rate, in practice, will be progressive in nature. It is possible due to the imposition of the tax not on the income, but on the particular category of expenses the scale of which depends on the social class of a taxpayer. Thus the richer will bear a greater burden of maintaining the public institutions which serve all citizens of the country. Their contribution will be even more substantial than the proportion relative to their income. As a result, such a system will lead to the redistribution of income in society. What is significant, Smith does not relate to the rich with excessive appreciation. He writes about their vanity and need to be admired, contrasting it with the plight of the poor. Far more social sensitivity can be seen here than when it comes to individualistic liberalism.

Parenthetically, in the further part of the section on the real estate tax, Adam Smith criticizes the so-called window-tax, the amount of which depends on the number of windows in a particular house. He considers this solution as bad and unjust because it harms the poor. The Scottish philosopher explains that modest rural homes often have more windows than exquisite urban residences<sup>19</sup>. In this case, social justice is the main argument against a certain form of tax.

The most interesting idea propounded by Adam Smith regarding the regulatory function of public levies can also be found in his *opus magnum*, *The Wealth of Nations*, but surprisingly not in the chapters which are dedicated to taxes. In the part dealing with public expenses and the justified duties of the state, the Scottish philosopher confirms that he is not an enthusiast of an intense activity of the state. However he turns out to be a supporter of some public investments in transport facilities: navigable canals, harbours, bridges and roads. Then he goes on to analyse the possible ways of financing such infrastructure<sup>20</sup>.

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<sup>19</sup> *Ibidem*, p. 846.

<sup>20</sup> *Ibidem*, p. 724.

He indicates that the cost of transport infrastructure maintenance should be borne directly by its users. As far as the level of fees is concerned, Smith proposes the principle of proportionality. Therefore, the toll should depend on the degree to which a particular user contributes to the infrastructure wear and tear. In the case of roads, the heavier the vehicle is, the higher the charges should be. However, the Scottish philosopher provides an exception to this rule. He says: “When the toll upon carriages of luxury, upon coaches, post-chaises, etc. is made somewhat higher in proportion to their weight than upon carriages of necessary use, such as carts, wagons, etc. the indolence and vanity of the rich is made to contribute in a very easy manner to the relief of the poor, by rendering cheaper the transportation of heavy goods to all the different parts of the country<sup>21</sup>”. Despite the fact that this passage does not strictly deal with the taxes but with other public levies, Smith proposes nothing else than a very progressive programme of redistribution. First, he believes that a higher toll for luxurious vehicles will not be noticeable for their wealthy owners (luxury vehicles are usually light so the total cost of road use would still be reasonable despite the higher rates). Their greater contribution to the costs of road infrastructure maintenance will help to reduce the fee for ordinary vehicles used in transport of various goods. As an economist, Smith believes that transport costs are ultimately borne by the final consumer. Thanks to the principle of proportionality, toll reduction will be most noticeable in the case of the goods which are cheap to produce but quite heavy. In their price, it is the transport costs that have the largest share. Such cheap but heavy goods are usually the most basic necessities (mainly simple foodstuffs e. g. wheat, vegetables, groats etc.) bought by the poor. Therefore, a higher toll for luxurious vehicles will result in lower prices of the basic victuals. Smith’s proposal concerning road maintenance turns out to be indirect income transfer from the rich to ordinary people.

Attention should be paid to the blunt and emotional description of the owners of the aforementioned luxury vehicles. In the passage cited above, Smith calls them “indolent” and “vanish”. Subsequently, it seems that his proposal is based not only on economic efficiency, but also on moral arguments. Apparently, Adam Smith's views on the issue seemingly unrelated to taxes turn out to be the irrefutable proof of his support of the concept of income redistribution.

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<sup>21</sup> *Ibidem*, p. 725.



It transpires that Adam Smith was a supporter of income redistribution and he would use taxes and other public levies for that purpose. He believes that taxation proportional to income is necessary to ensure equality but sometimes that is not enough and progressive tax is also acceptable at times.

### ***The stimulating function of taxes in Adam Smith's views***

Arguments for Adam Smith's support for the next function of taxation can also be found in his proposals for the fiscal system in *The Wealth of Nations*. The first public levy analyzed by Adam Smith in Chapter 2 of Book 5 of his *opus magnum* is a tax on the rent of land<sup>22</sup>. Although the amount of the tax actually paid depends on the amount of the land owned, it is not a tax on real estate in the modern sense. In those days, most of the nobility didn't cultivate their land by themselves, but rented cropland to individual farmers. The income from the lease of land constituted the tax base. Therefore, according to contemporary criteria, the tax on the rent of land should be classified as an income tax. In practice, in Adam Smith's times, tax assessment was not made on the basis of real income from the rent. Landowners' revenue was based on the land valuation that had been made many years before. Those regulations are the subject of the Scottish philosopher's criticism. He believes that a tax determined in that way is unequal and not related to the actual income<sup>23</sup>. Smith is committed to the task of finding a better solution to the land tax.

The author of *The Wealth of Nations*, in his research into land-rent taxation, uses his favourite comparative methodology. He compares British regulations with the tax laws existing in France and Venice. On this basis he comes to the conclusion that may seem obvious these days: the tax should amount to a certain percentage of the actual rental fee. Smith believes that the introduction of such a tax will be possible after the establishment of a public register of contracts<sup>24</sup>. That proposal is relevant to my research into the functions of taxation in Adam Smith's thought as such a comprehensive database would enable the implementation of the taxes which perform the stimulating function. It must be noted, however, that the Scottish philosopher's support for the establishment of a public register of civil contracts in itself

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<sup>22</sup> *Ibidem*, p. 829.

<sup>23</sup> *Ibidem*, p. 828.

<sup>24</sup> *Ibidem*, p. 830.



is an interesting argument in the debate concerning Smith's views on political economy. What is more, he goes so far as to propose criminal liability for reporting false information to that register<sup>25</sup>. The thinker who advocates the expansion of bureaucracy in order to increase tax justice cannot be considered as a libertarian or neoliberal any more.

Coming back to the issue of the stimulating function of taxation, the full knowledge of the provisions of each land-lease contract coming from the public register allows the state to levy different taxes on rental income from each contract, depending on the conditions provided in it. This paves the way for the state to promote certain (e.g. publically beneficial) forms of land-lease by lower levies (or discouraging from undesirable clauses in contracts by higher taxation). Adam Smith, the liberal, does not miss such an opportunity for social engineering.

In his further analysis, the Scottish philosopher describes two ways of payment for land-lease. First, there is the standard rent - periodic fees paid throughout the duration of the whole contract. The second method of payment is a one-time fee for the renewal of the lease. Smith is very critical of the latter solution: "This practice is in most cases expedient of a spendthrift, who for a sum of ready money sells a future revenue of much greater value. It is in most cases, therefore, hurtful for the landlord. It is frequently, hurtful for the tenant, and it is always hurtful for the community. It frequently takes from the tenant, and it is always hurtful to the community"<sup>26</sup>. Smith not only points out that the contract is disadvantageous for both parties, but also stresses the negative social impact in a wider context. The author of *The Wealth of Nations* wants the state to discourage people from entering into such harmful agreements: "By rendering the tax upon such fines a good deal heavier than upon the ordinary rent, this hurtful practice might be discouraged, to the no small advantage of all the different parties concerned, of the landlord, of the tenant, of the sovereign, and of the whole community"<sup>27</sup>. He wants to use taxes to influence the choice between one and the other form of agreement between two private parties. This is a perfect example of the (un)stimulating function of taxes<sup>28</sup>.

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<sup>25</sup> *Ibidem*, p. 831.

<sup>26</sup> *Ibidem*.

<sup>27</sup> *Ibidem*.

<sup>28</sup> It seems that both stimulating and unstimulating functions of taxes can be found in this case. Tax policy proposed by Smith encourages raising the ordinary rent while discouraging from collecting renewal fee. A tax where the unstimulating function appears alone is, for instance, an excise duty on alcohol the main function of which is to discourage people from drinking spirits. At the same time, it doesn't encourage people towards alternative forms

It is noteworthy that Smith's attempt to protect landowners from themselves must be regarded as a manifestation of state paternalism rejected by many prominent classical liberals such as John Stuart Mill and Wilhelm von Humboldt<sup>29</sup>.

Other examples of unstimulating function of taxes can be found in the Scottish philosopher's proposals of the tax on the rent of land. He considers many practices popular among landowners as socially harmful. To eliminate them from economy, he recommends levying higher taxes on contracts containing clauses regulating methods of land cultivation, the type of crop, certain succession of the crop etc.<sup>30</sup>. Smith believes that the farmer has better knowledge than the landowner. Therefore, limiting the use of farmland would be economically inefficient and such a contract would be harmful for the tenant. Apart from the unstimulating function of taxation, the way of thinking similar to the economic analysis of law can be encountered here.

Yet another example of the stimulating function of taxation in Adam Smith's proposals is worth discussing because it is significantly ahead of the times of the author of *The Wealth of Nations*. The Scottish philosopher notes that another way of taxation of the owners who choose self-cultivation of their land has to be found. In case of the lack of an agreement, which can be entered into the public register, what he advocates is possible income estimated on the basis of the value of land-lease contracts from the neighborhood as the proper tax base. Interestingly, Smith suggests that the amount of tax levied on the land owners who decided to cultivate their land by themselves should be slightly reduced compared to the amount resulting directly from the estimation described above. He believes that cultivation of the cropland by its noble owner would be beneficial to society: "It is of importance that landlord should be encouraged to cultivate a part of his own land. His capital is generally greater than that of the tenant, and with less skill he can raise a greater produce. The landlord can afford to try experiments and is generally disposed to do so. His unsuccessful experiments occasion only a moderate loss to himself. His successful ones contribute to the improvement and better cultivation

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of behaviour. These considerations are purely theoretical. Distinction between stimulating and unstimulating functions of taxes does not seem to have much impact on the functioning of the fiscal system.

<sup>29</sup> J. Kleining, *Paternalism*, Manchester 1983, p. 24.

<sup>30</sup> A. Smith, *op. cit.*

of the whole country”<sup>31</sup>. As this excerpt from *The Wealth of Nations* demonstrates, the main reason which Smith gives for reducing the taxes for landlords who decide to cultivate their land by themselves is the hope for innovations in agriculture which can be introduced by landlords who have the capital to invest. There is no doubt of the outline of the stimulating function of taxation, but what is more amazing is the fact that Adam Smith came up with the idea of tax reductions for the research and development in the mid 18<sup>th</sup> century!

A brief analysis of the ensuing Adam Smith’s proposals for the fiscal system proves that the stimulating function of taxes is easily identifiable in the ideas of the Scottish philosopher. He finds taxes as a good measure for encouraging people towards specific behaviour or discouraging them from it. Smith believes that the state should occasionally resort to taxes not only to secure the common good but for paternalistic reasons also.

## **Conclusion**

There is no doubt that Adam Smith is one of most prominent liberal economists in history. He was a devoted advocate of economic rationality and free market. However, even such a brief analysis of the functions which he designed for the particular taxes shows that the Scottish philosopher believed that the night-watchman state is definitely insufficient. He was sure that the rich should contribute more to the common good than ordinary people. He was convinced that the state should intervene in the market from time to time.

He treated taxes as a good tool to improve society. He agreed that taxes can also serve other functions besides the fiscal one: they can be used for redistribution of income or for discouraging people from harmful behaviour. On the other hand, Smith thought that tax reductions might inspire people to do something not only in their own interest but also for the common good. Surely, the author of *The Wealth of Nations* is liberal and his support for the free market and private property is strong. But he does not treat those values as dogmatically as neoliberals or libertarians do. His views on the functions of taxes are an irrefutable proof of this. Probably the Scottish philosopher would not vote for Ronald Regan nor would he agree with Murray Rothbard.

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<sup>31</sup> *Ibidem*, p. 832.

### **Adam Smith's View on the Functions of Taxation.**

**Summary:** The father of classical economics, Adam Smith is known for the metaphor of the invisible hand. It evokes associations between him and radical supporters of free market and the night-watchman state. The analysis of his views on the functions of taxation can help one verify how much he is committed to “the invisible hand of the market”. Taxation has three main functions: fiscal, regulatory and stimulating. Radical economic liberals and supporters of the minimal state allow merely the fiscal function. Adam Smith believes that taxes and other public levies should be used for income redistribution. It can be seen in his analysis of taxes on house-rent and toll road charges. Therefore, he supports the regulative function of taxation. What is more, he proposes using taxes to promote particular forms of land-lease contracts, which are more beneficial to society than others. He also suggests tax reductions for research and development. Consequently, he also supports the stimulating function of taxation. In conclusion, Adam Smith is one of the most prominent liberal economists, but he is far from being neoliberal or libertarian. He believes that the state should occasionally intervene in the economy and that taxes are proper tools for such interventions.

**Key words:** Adam Smith, taxation, the invisible hand of the market.